

PREFACE

The so-called classical system of current U.S. tax law treats corporations and their investors as separate entities and levies tax at both the corporate and shareholder levels on earnings from investments in corporate equity. Corporate earnings distributed to lenders as interest are generally deductible by the corporation and taxed, if at all, to the lender. Investors who conduct business activity in noncorporate form, such as a sole proprietorship or partnership, are taxed once on their earnings at the owners' tax rate.

As a result, despite the critical role played by corporations as a vehicle for economic growth, the United States tax law often perversely penalizes the corporate form of organization. The current system of taxation also distorts corporate financial decisions—in particular by encouraging debt and discouraging new equity financing of corporate investments. The tax system also prejudices corporate decisions about whether to retain earnings or pay dividends and encourages corporations to distribute earnings in a manner to avoid the double-level tax.

Integration of the individual and corporate tax system would tax corporate income once and reduce or eliminate these economic distortions. Most trading partners of the United States have integrated their corporate tax systems. The potential economic gains from integration are substantial.

This Report examines in detail several different integration prototypes, although it does not attempt an exhaustive discussion of all possible integration systems or of all the technical issues raised by the alternative prototypes.

This Report does not contain legislative recommendations. Rather, it is intended to stimulate discussion of the various prototypes and issues they raise. By advancing the opportunity for such debate, this Report should encourage serious consideration of proposals for integrating the individual and corporate tax systems in the United States.